The Benefits of Tax-deductible Equity

A Senior Honors Thesis

Presented in Partial Fulfillment of the Requirements for graduation with distinction in Finance in the undergraduate colleges of The Ohio State University

By

Ann Cleary

The Ohio State University
August 1997

Project Advisor: Professor Timothy Opler
Department of Finance

THESIS ABSTRACT

THE OHIO STATE UNIVERSITY
FISHER COLLEGE OF BUSINESS

NAME: Ann Cleary

QUARTER/YEAR Summer/1997

DEPARTMENT: Finance

DEGREE: BSBA

ADVISOR'S NAME: Opler, Timothy

TITLE OF THESIS:

"The Benefits of Tax-deductible Equity"

Since the creation of tax-deductible preferred in late 1993, this form of financing has been a popular means of financing. The main attraction for issuers is the ability to essentially increase equity levels while taking advantage of the tax-deductibility of debt. This paper discusses the issues involved in issuing tax-deductible preferred and the performance results of the issuers over time.

After assessing the need to increase capital within a corporation, three main options are available to attain this goal: the issuance of preferred stock, bonds or tax-deductible preferred. If the corporation chooses to issue preferred stock, the percentage of equity in the company will increase thus decreasing the risk associated with the company and increasing its credit rating. If bonds are chosen, the level of debt within the company increases and therefore the risk associated with an investment in the company. The attractiveness of issuing bonds arises from their tax-deductibility. The third option is to issue a relatively new combination of the above called tax-deductible preferred.

Tax-deductible preferred or tax-deductible equity as it is often called, is a hybrid of bonds and corporate stock. This investment essentially consists of an issuance of debt disguised as valuable equity. Specifically, the parent company forms a subsidiary or "special purpose vehicle" fully controlled by the parent company. The subsidiary then issues the certificates for this deeply subordinated debt and "loans" the proceeds to the parent. The parent in turn pays "interest" on this loan, which is actually the coupon payment to the investors. This payment, classified as interest, is tax-deductible and free from corporate level tax. In addition, the subsidiary pays no taxes of its own. A detailed explanation of a basic issuance of tdp is explained below:

The Subsidiary:

The first step in issuing tdp (tax-deductible preferred) is for the parent company (the issuer) to form a subsidiary. The subsidiary then purchases a Subordinated Note from the Parent. The payment for the note is created with the cash proceeds of the tax-deductible preferred offering.

The Investor:

The holder of the tdp shares receives dividends monthly, from which the investor is not subject to withholding tax.

The Parent:

The interest payments on the debt to the subsidiary are equal to the monthly dividend payments to the investors. The interest payments may be deferred for up to five years without causing an event of default, thus producing an equity-like safeguard.

The subsidiary which is necessary to issue tax-deductible preferred, can be formed in several ways. The first and original option is to form a domestic limited partnership or a domestic limited liability company. This type of partnership requires the filing of a K-1 partnership tax disclosure. To avoid the somewhat complicated and costly K-1 tax filing, the issuer can form a grantor trust which requires a Form 1099, the common filing for most dividend and interest income.

Tax-deductible preferred appears very attractive to the issuer for three main reasons:

- All companies strive to increase their credit ratings in hope of gaining more favorable borrowing rates. Rating agencies such as Moody's and Standard and Poor's consider TDP as equal to an issuance of preferred stock. The basis for this theory lies in the ability to defer coupon payments to investors and the deep subordination features.

- Issuing preferred stock serves the purpose of increasing equity; however, the tax implications are costly to the issuing corporation. By issuing TDP, a corporation is paying "interest" on the loan from its subsidiary. This payment of interest, which is the coupon payment to investors, is considered debt by the IRS and is therefore tax-deductible.

- Finally, accounting firms do not create a discrepancy as the classification of TDP. Instead, TDP is classified as "minority interest" on the corporation's balance sheet. This is justified by the fact that the securities are actually issued by the subsidiary of the Parent and therefore can be classified as minority interest. Thus eliminating any effect on the debt ratios.

In addition, the interest deferral feature of five years basically negates any difference between issuing trust TDP and perpetual preferred. The five-year deferral allows an extension of the interest payment period without creating a recognized default.

The investor also benefits from the purchase of the hybrid securities. Essentially, the investor is the legal owner of undivided interest in the debt obligation of the parent, not just the subsidiary. In addition, in the case of bankruptcy, the classification of subordinated debt ranks higher in seniority than all equity investors.

Determination of terms

The length of maturity of tax-deductible preferred is based on the issuer's credit standing and tax parameters. The length generally ranges from 30 to 50 years, however; recently perpetual offerings have been issued, which are also callable after five years. The dividend rate is set in a similar manner, also based on the issuer's credit standing. The issuer may not redeem the debt before the fifth year. At that time, the option is open to redeem the debt at par plus all accrued and unpaid interest.

A comparison of issuance expenses

At the bottom line, cash savings can be calculated by noting the savings created by the tax-deductibility of tax-deductible preferred. For example, assume an issuance of $100 million. The required dividend payment on preferred stock at an interest rate of 9% is $9 million. If the issuance is in the form of tax-deductible preferred at the same rate of 9% the required interest payment is still $9 million. The savings are found in the after-tax cost of the payment. Assuming a 35% tax rate, the interest payment would actually be $5.85 million ($9million * .65) creating a cash savings of $3.15 million over the preferred stock issuance. Based on this information, the rationale of a corporation issuing tax-deductible preferred only to buy back its preferred stock is clear.

For corporations considering an issuance of tax-deductible preferred, the initial costs of issuance are important to consider. The following presents the estimated costs associated with a $200 million issuance of tdp by means of a trust subsidiary, as of 1995:

Category	**Estimated Cost**
SEC Registration Fee*	$86207
NYSE Listing Fee	50000
Blue Sky Fees and Expenses	20000
Printing Expenses (variable)	40000
Legal Fees and Expenses (variable)	150000
Accountants' Fees and Expenses (variable)	125000
Ratings (calculated at 3bps of principle)	120000
Trustee Fees and Expenses	20000
K-1 Expenses (annual)	112500
Incorporation of Trust	15000
Miscellaneous	30000
TOTAL	**$768707**

* (Equal to 1/29 of 1% of total principal of debt securities registered)

Although this figure may appear to be a significant initial outlay, when the annual savings of $3.85 million are compared, the annual costs seem fairly irrelevant.

The U.S. Treasury

At first glance, the issuance of tax-deductible preferred might seem too good to be true. Considering looming action of the U.S. Treasury, that may be the case. In late 1995, the Clinton administration proposed a plan to raise $28 billion from corporations over the next seven years. The plan limits the tax-deductibility of a wide range of debt, including tax-deductible preferred. The department claims "allowing equity to be claimed as debt erodes the corporate tax base."[1] However, the attacks on such debt will only raise $1.6 billion of the proposed $28 billion over the projected seven years.

As of March 1997, the treasury had not yet implemented the plan to limit tax-deductible preferred. Previously, the treasury had proposed completely banning the issuance of tax-deductible preferred. Recently, the proposal has been revised to limit the issuance of tdp to a maximum maturity of fifteen years. Maturities greater than fifteen years would be not be eligible for the tax-deductibility. In a testimony by Arthur D. Hyde, Managing Director and Head of Corporate Debt at Salomon Brothers Inc., he contends that the proposed legislation would cause issuers to choose hybrid securities with a maturity of less than fifteen years or forego the tax-deductibility and continue with the fifteen-plus-year maturity. In this scenario the dividends would be disbursed directly by the parent, resulting in a higher cost of capital. As an expert in the field, Hyde claims that when cost is involved, few companies would substitute hybrid financing with equity, other means of financing would be considered.[2]

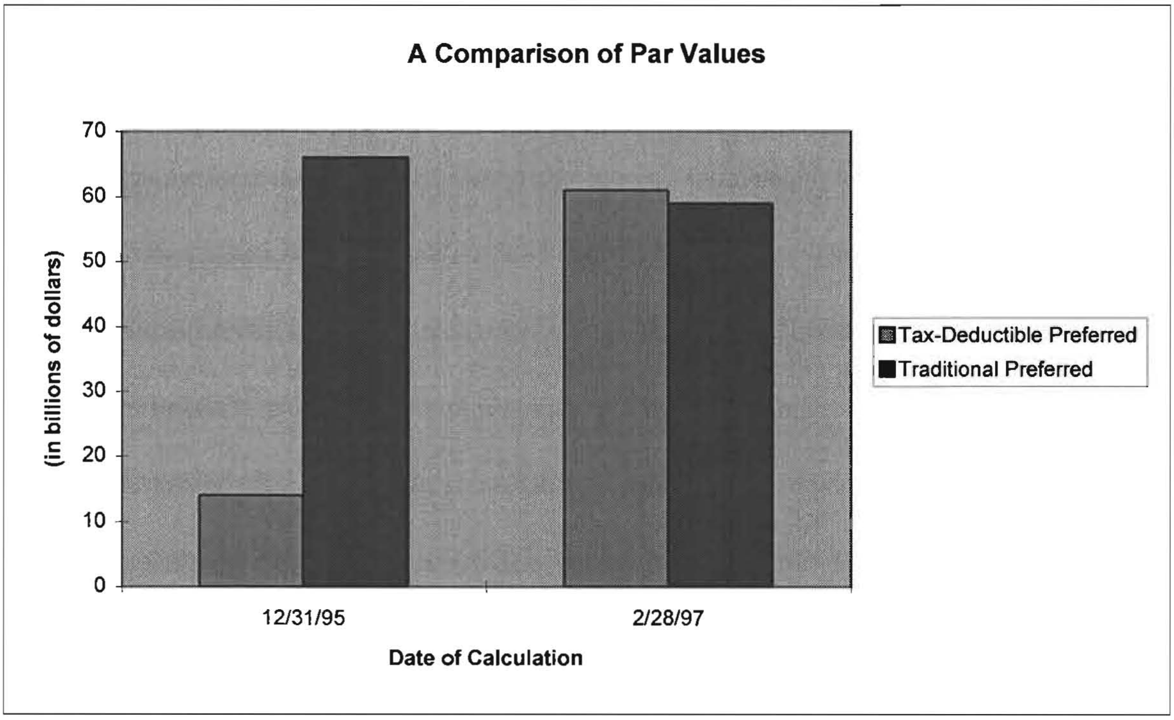
If Hyde's view is accurate, the ruling on limiting the tax-deductible preferred will not recover the level of tax dollars the government has budgeted. An additional congressional testimony by Donald Crumrine, Chairman of the Board Flaherty & Crumrine, noted the surge of corporations issuing tax-deductible preferred and buying back their traditional preferred stock. His proposal is based on the government's plan to

---

[1] Wall Street Journal 12/8/97

[2] Hearing of the House Ways & Means Committee, Federal News Service, 3/12/97

reduce the Dividends Received Deduction from 70% to 50%. As the percentage of deduction decreases, the attractiveness of purchasing equity decreases and tax-deductible preferred appears as a better investment. The following chart displays a calculation made by Flaherty and Crumrine to analyze the tax-deductible preferred and traditional preferred markets.[3]



The data shows the substantial increase of tax-deductible preferred from par values outstanding totaling $14 billion in 1995 and $61 billion in 1997. The opposite reaction was found in traditional preferred where the par value outstanding decreased $7 billion over the two year span. "Further shrinkage to around $50 billion is already well assured, which would represent a contraction of almost 25% from 1995."[4] A substantial decrease in the world's only well developed preferred stock market. A large cause of the decrease

[3] Hearing of the House Ways & Means Committee, Federal News Service, 3/12/97

consists of companies issuing tdp to refund callable traditional preferred stock. This effect will further reduce the level of traditional preferred outstanding as noted in the predictions above. The proposal to lower the DRD further decreases the economic incentives of issuing traditional preferred.

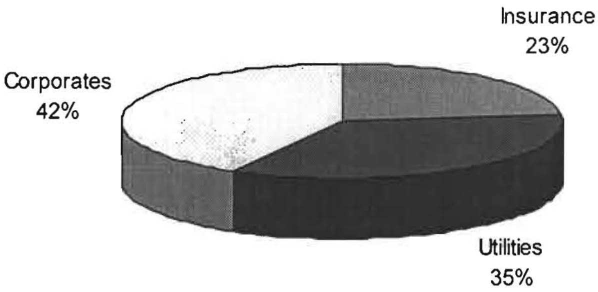
Analysts are contending that the congressional actions do not only result in a negative effect for the issuers, but also for the economy as a whole. The increase in the cost of capital for corporations and state and local government discourages capital investment by these organizations which will weaken the overall economy. The Treasury must decide if the additional tax revenue outweighs the proposed negative effects on the economy.

Market Dynamics of Tax-deductible Preferred

The discrepancy in the Treasury is not slowing down the issuance of tdp; in fact some companies are rushing to the market to beat the pending ruling, as the issuances would be guaranteed under a grandfather clause. A variety of companies dealing in many different industries issue tax-deductible preferred. According to a 1995 market survey of its tdp issuances, Goldman Sachs found the following breakdown by industry:

[4] Donald Crumrine, Hearing of the House Ways & Means Committee, Federal News Service, 3/12/97

Tax-deductible Preferred Issuers



As seen above, a concentration exists in the insurance and utilities industries. The insurance industry in particular issued $6.43 billion during 1996, compared to its $2 billion in 1995.[5] Major industry leaders such as Allstate and Conseco were of the larger issuers. The concentration of utility providers is a result of the level of preferred stock outstanding that this industry averages. Utility companies have found tax-deductible preferred to be the most cost-effective strategy in the attempt to buy back outstanding preferred shares and replace the level of equity with tdp.

Recently, a new surge has been noticed in the banking industry. Issuers during 1996 include Chase Manhattan Corp., BankAmerica Corp., First Bank System, Wells Fargo & Co., J.P. Morgan and Bank America.[6] The popularity is due to the Federal Reserves' announcement in October 1996 stating that Bank Holding Companies can classify an issuance of tdp as Tier One Capital. To achieve this status, the tax-deductible preferred must meet two requirements: a minimum of a five-year consecutive deferral period and the longest possible maturity, preferably of perpetual length. This may result

[5] Insurance Finance & Investment, "The Year In Review: 1996", Vol.1, No.24; Pg.6
[6] Padgett, Tania. "Market for Trust Preferred Securities May Soon Suffer From Oversaturation." The American Banker, 12/19/96 pg.1

as a short-term fad considering the Treasury actions proposed to limit the benefit of the classification. The Fed is considering placing a limit at 10% of consolidated total capital or 40% of total allowable capital. Beyond this limit, the tax deductibility would no longer apply and the benefit of issuing tax-deductible equity would be nullified. In addition, concern exists that the market for the capital will become quickly saturated and the banks will have to compete and offer higher yields to attract investors.

The Options Presented By Investment Banks

The leaders of the Investment Banking industry each have slightly different versions of the common product: tax-deductible preferred. Goldman Sachs pioneered the investment in late 1993 with its MIPS product and continues to hold the greatest market share in the industry. Merrill Lynch follows close behind with its own version of MIPS, called TOPRs. Recently, Salomon Brothers created another competitor in the market with the introduction of Trups. The main difference between Trups and MIPS is the dividend deferral feature. Trups do not have a dividend deferral, but they can be converted into straight preferred at any point.

International Offerings- UK MIPS

On an international level, foreign companies have begun issuing tax-deductible preferred by opening an operating subsidiary in the U.S. through which the tax-deductible payments are distributed to investors.

Pioneered by Goldman Sachs in late 1994, the offerings of tax-deductible equity have expanded outside of the US. The offering parallels traditional MIPS in that the securities are issued through a special-purpose subsidiary, which lends the proceeds to the parent who will in turn make tax-deductible interest payments on this loan. The difference in the UK MIPS arises after this transaction when the parent relends the proceeds of the loan to an operating subsidiary in the US. This subsidiary can then make the tax-deductible payments. The shares are perpetual and have an unlimited interest deferral option.[7]

Data Analysis

In theory, tax-deductible preferred appear as an optimal choice for most firms looking to increase equity. The tax-deduction and favorable ratings considerations are additional incentives to such an issuance. To determine the effectiveness of tax-deductible preferred, an analysis of the stock performance of firms who have issued tax-deductible preferred since the creation in 1993 through May 1996 has been completed. The firms were divided into categories as follows: Financial, Industrial, Insurance and Utilities. An additional category was created for Banks, but the surge in this industry began in the latter part of 1996, too recent for historical comparison. Information was obtained through Merrill Lynch in a report detailing the 166 issuances of tax-deductible preferred during the period of October 1993 though March 1997.

Credit Ratings

Initially, an assumption was made that companies' with lower credit ratings would issue large amounts of tax-deductible preferred in hopes of substantially increasing equity and thus ratings. Of the 166 issuances completed between the original in October 1993 through March 1997, seventy-two of the parent company's had credit ratings of

[7] "Cadbury Issues UK MIPS." Corporate Financing Week (April 10, 1995) pg.6

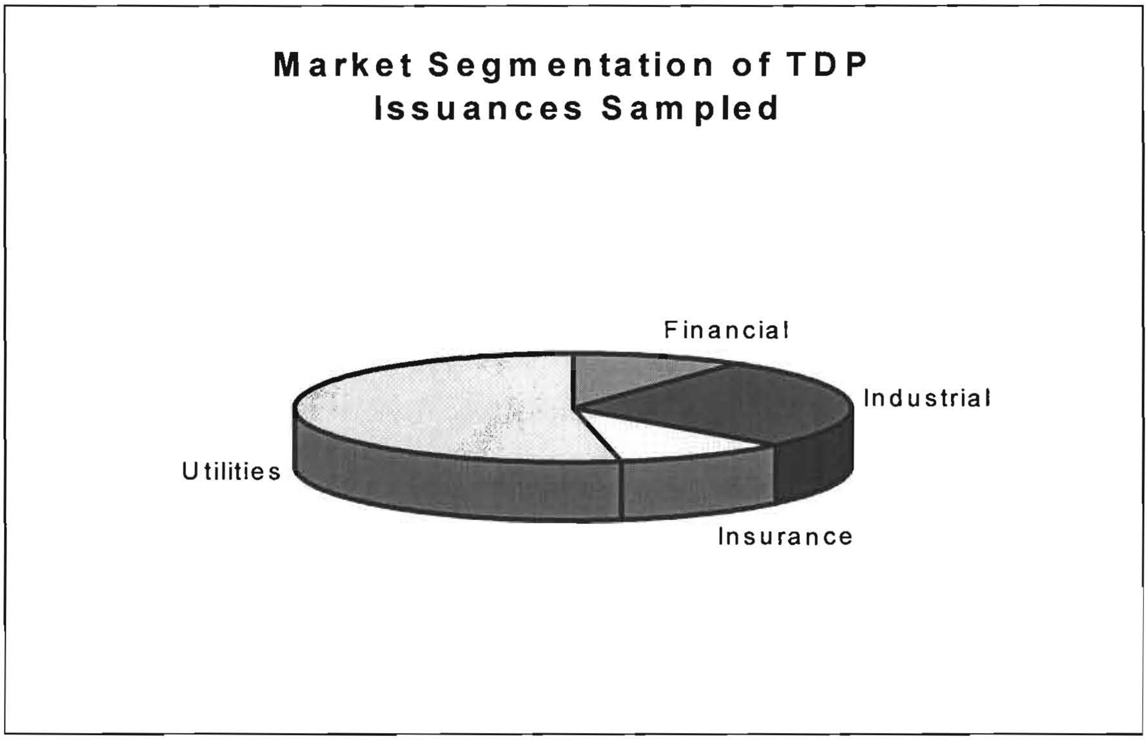
Standard & Poors' AAA- or better and ninety-four had credit ratings of BBB- to BBB+. This data shows the greater percentage of company's with lower credit ratings finding tax-deductible preferred to be an optimal choice in hopes of boosting credit ratings and equity. The firms possessing higher credit ratings may have issued to increase ratings also or to take advantage of the tax deduction.

The average issuance was $194.8 million overall. The issuers with credit ratings of AAA- or better averaged $224.8 million whereas the issuers with credit ratings below BBB+ averaged $164.8 million. One may assume that the firms with the higher credit ratings were larger and more stable, thus allowing for a larger issuance to be accepted.

Stock Return Comparison

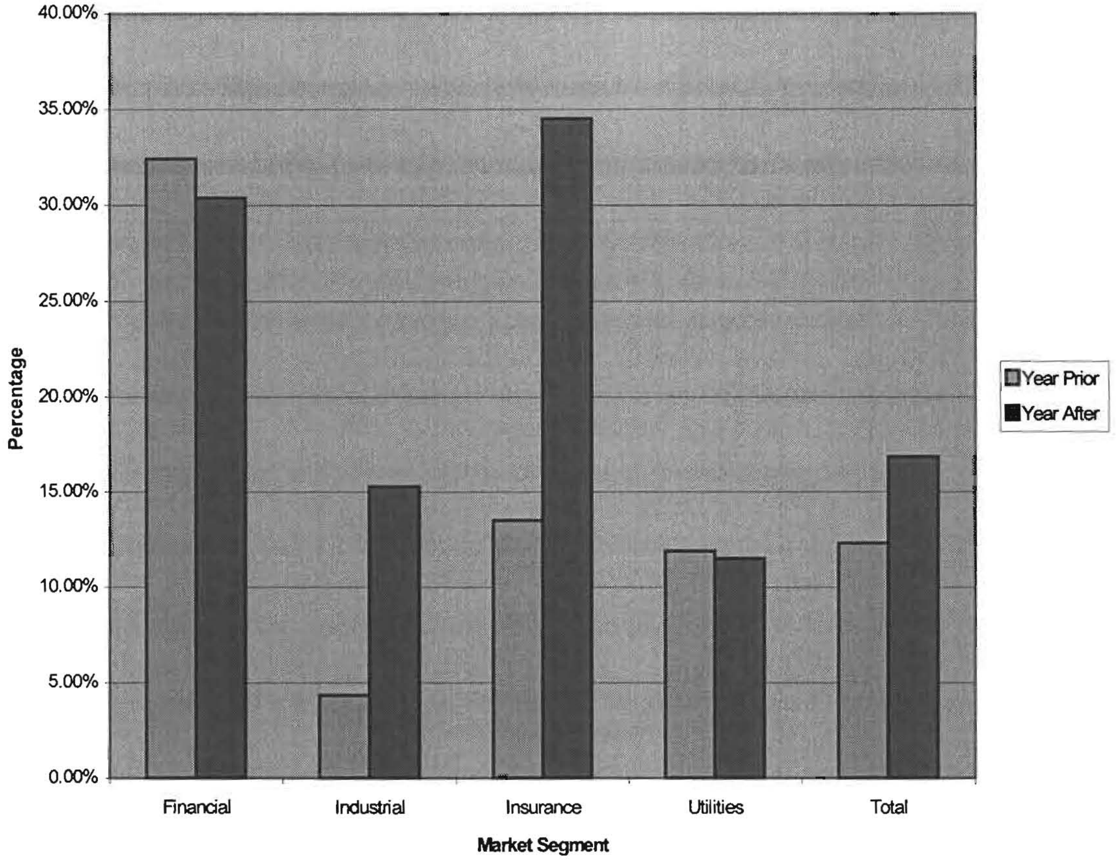
The comparison of stock returns one year prior to an issuance of tax-deductible preferred and one year after the issuance was calculated. The exact date of the issuance was used and the stock price on this date one year earlier and later were used for comparison. The percentage change was calculated in both instances. Stock prices were retrieved from Microsoft Investor and in a few cases, weekly averages were used for stock prices needed prior to 1995.

Eighty-nine issuances completed between October 1993 and May 1996 were utilized in this stock comparison. The exhibit below displays the market segmentation. Over half (53%) of the issuances were developed for utilities companies, 27% for industrial companies, 10% for insurance companies and 10% for the financial sector.



The results of this comparison are shown in the table below. For the year prior to the issuance, the average of all of the stock results combined produced an increase of 12.3%. The average for the year after the issuance resulted in an increased return at 16.86%. A comparison was then made for each market segment. The financial sector returned 32.4% in the year prior and 30.35% in the year after. The industrial sector returned 6.97% in the year prior and 14.8% in the year after. The insurance segment returned 13.51% in the year prior and 34.51% in the year after. Finally, the utilities industry returned 11.87% in the year prior and 11.5% during the year after.

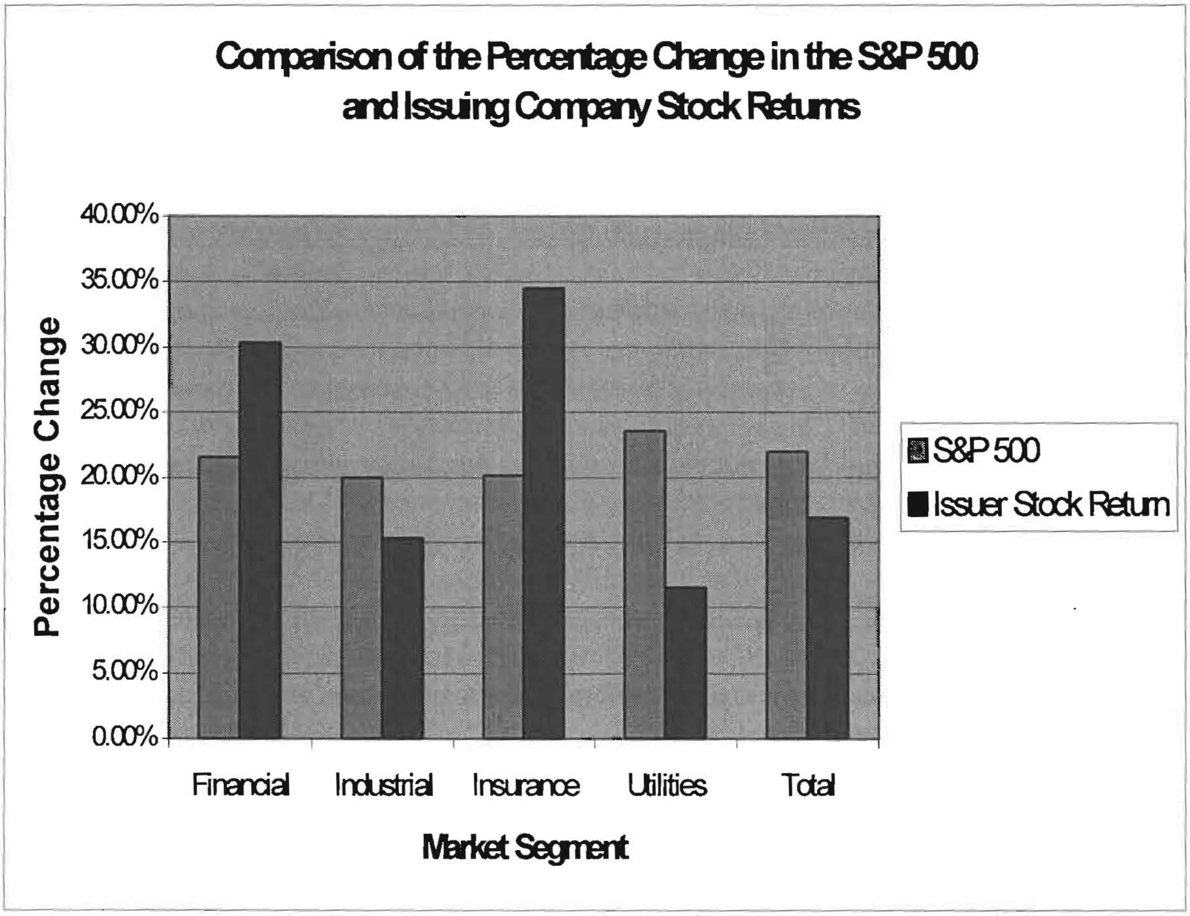
Stock Price Comparison: One Year Prior and One Year After TDP Issuance



When all of the stock prices of the sampled companies the average gain was 12.3% in the year prior to issuance and 16.85% in the year after issuance. This figure can be used as a generality, but great variability was found in each of the market segments. The financial sector remained strong with only a minimal decrease. The industrial sector more than doubled its return in the year after. The insurance sector boomed from a 13.51% return to 34.51% the next year. Finally, the utilities industry remained relatively constant. These results tend to show that tdp may be more favorable for some industries, possibly industrial and insurance companies, than others. A comparison to the S&P 500 returns for the dates of the applicable "year afters" will provide a steady benchmark to judge the relative values of each return.

Comparison to the S&P 500

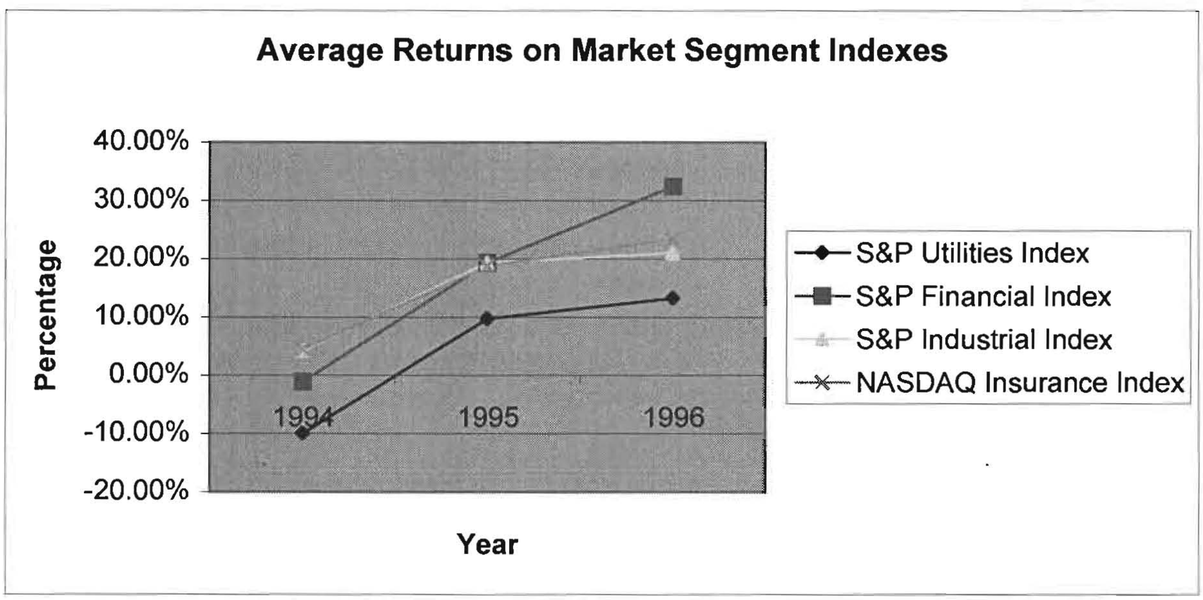
The returns from the S&P 500 were gathered for each of the issuance dates and one year after issuance. The percentage change was then calculated. These figures were then compared to the returns from each of the companies' sampled. The average gain of the S&P 500 during the year after for each issuance was 22.04%. The returns of the S&P 500 for the dates of issuance from the financial sector returned 21.54%, the dates pertaining to the industrial sector returned 19.97%, the S&P 500 averaged a 20.14% return for the dates required by the insurance segment and 23.53% for the dates pertaining to the utilities segment. A comparison of the return of the S&P 500 and the "year after" company stock returns is found in the table below.



From this chart one can see that the S&P 500 outperformed the average company issuing tax-deductible preferred by 5.15%. This trend was found in the industrial and utilities segments which fell behind the S&P 500 by 4.69% and 12.03% respectively. On the up side, the financial and insurance sectors outperformed the S&P 500 by 8.81% and 14.37% respectively. Before making an assumption that tax-deductible preferred fairs well in certain industries and not in others, a comparison to the returns found by each market index must be examined.

Comparison to the Market Segment Indexes

To accurately judge the performance of each of the market segments, a comparison was made to the applicable market index. Average percentage returns were calculated from the S&P Financial, Industrial and Utilities Indexes and from the NASDAQ Insurance Index for the years 1994, 1995 and 1996. The results can be found in the following table.



The chart displays the growth of each of the indexes between 1994 and 1996, indicating that a majority of the companies used in the index have experienced increasing returns over the period. This data is for the purpose of a benchmarking the actual stock returns calculated for the companies issuing tdp. For example, ConAgra, one of the company's in the sample, issued tax-deductible preferred on 1/26/95. The company's stock value increased 12.04% in the year prior and 17.27% in the year after the issuance. These values can be compared to the index to determine the real growth, which may be a direct result of the issuance. During 1995, the S&P Industrial Index returned 19.33% and 21.00% in 1996. One can see that ConAgra was outperformed by the index in both 1995 and 1996. The value of ConAgra stock did increase by 5% over the prior year. Further analysis in the future may show that the efficiencies of an issuance may payoff gradually with higher returns, not necessarily only during the year after. This exercise would be a very beneficial test for the issuing companies to judge just how well the company is performing in relation to its competitors.

On a broader spectrum, generalizations can be determined as to the productivity of each of the market segments in comparison to their respective industries. The utilities industry saw a decrease in 1994 of –9.97% and then a substantial increase during 1995 of 9.72% and in 1996, 13.24%. When analyzing these returns over a few years, it is important to note the decrease during 1994. These results can be compared to the issuing company results'. During the year prior, the companies issuing within this industry averaged a gain of 11.87% and 11.5% during the year after. These figures are relatively in line with the index. Considering the tendency toward a decrease during 1994, the issuing companies in this industry seem to be performing quite well over the three-year period.

The S&P Financial Index displayed quite an increase since 1995. During 1994, the index decreased slightly by 1.17%. This was followed by a recovery in 1995 with an increase of 19.3% and then a boom in 1996 with another increase, this time 32.41%. The financial companies included in the sample performed strongly during both the year prior and the year after with increases of 32.40% and 30.35% respectively. This tends to show that the ten financial companies issuing tdp tended to precede the general increase in the industry.

Similar to the other indexes, the S&P Industrial Index displayed a low return in 1994 and then increases during both 1995 and 1996. During 1994 the increase was only 4.16% and then 1995 the increase was 19.33% followed by a 21.00% increase in 1996. The industrial companies issuing tax-deductible preferred returned stock increases of 4.34% in the year prior and 15.28% during the year after. Considering the averaging of issuance dates over the past few years, these returns tend to be in line with the index for the year prior, however a year after the issuance is generally during 1995 and 1996 which should lead to a higher return. Overall, the industrial companies did not seem to break away from the market because of the issuance.

The insurance industry appears to be the strongest performer after issuing tax-deductible preferred. The NASDAQ Insurance Index showed an industry increase of 4.43% during 1994, 18.76% in 1995 and 23.40% in 1996. The issuing insurance companies averaged an increase during the year prior of 13.51% and a substantial increase of 34.51% during the year after. The return in the year prior, 13.51%, seems to be roughly in line with the average of the 1994 and 1995 returns, 4.43% and 18.76% respectively. More substantial in importance would be the 34.51% increase found in the year after. This is considerably above the industry average leading to the belief that issuing tax-deductible preferred in this industry leads to a more profitable company.